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MEMORANDUM

TO: ALL EXAMINERS AND PROFESSIONAL STAFF

FROM: GEORGE A. REYNOLDS, CFE, CEM, CPA
SENIOR DEPUTY COMMISSIONER

SUBJECT: LENDING TO CORPORATIONS, LLC'S AND THEIR RELATED INTERESTS

DATE: OCTOBER 5, 2001

The Department has been reviewing the issue of lending to related persons, corporations, limited liability corporations (LLCs) and other entities for some time. The purpose of this Memorandum is to provide additional guidance to bankers and to our examination and professional staff regarding such debt. The majority of Georgia State-chartered banks follow safe and sound practices regarding lending to related interests. In a few instances, the Department has become aware of credit relationships where loans have been made on an individual project or development basis to multiple individual corporations or limited liability corporations, creating a substantial level of concentration risk to financial institutions. In some cases, this concentration risk to these related interests is many times the capital position of the bank.

There may be sound, business-related reasons for setting up projects and developments using such a structure. However, we want to remind bankers that under 7-1-285 of the Financial Institutions Code:

> *The liabilities of a group of one or more persons or corporations or both may be considered as owed by one person or corporation because the group relies substantially on a common source for repayment of its obligations or makes a common use of funds received by it.*

This is further amplified by our regulation Rule 80-1-5-.01(13) which states:

> *"The Department of Banking and Finance shall consider the liabilities of separate person, corporations and entities to be combined for lending limits purposes, when there is no evidence of a separate source of repayment, there is an apparent lack of ability to service the obligation from the operations of the*

separate person or corporation without relying on a related source of repayment or where the separate entities make common use or are dependent upon funds of the group. "Related" shall mean connected by corporate or business structure or by common use or dependence upon funds, facilities or personnel."

It has come to the Department's attention that certain banks are permitting Acquisition and Development borrowers to establish a different LLC or Corporation for each loan (or development project) made to the borrower. These LLCs represent shell corporate entities with limited or no financial capacity or assets beyond the construction project being financed.
It appears that some banks are considering these types of entities as separate borrowers for legal lending limit purposes.

The Department wants it to be clearly understood that it is our expectation that in order for related corporations or LLCs to be subject to separate loan limitations, each corporation or LLC must be a self sustaining entity, is properly able to service its obligations without relying upon common sources of funding, and also does not depend upon common facilities, structures or personnel. The Department is particularly concerned about instances of "shell" corporations or LLCs, with no financial or operational history, assets or financial capacity outside of a single project or development and no secondary sources of repayment outside of that project other than the guarantor/principal of the company or LLC.

In addition to statutory and regulatory requirements, this issue has a primary relationship to the risk management practices of a financial institution. Concentration risk is a key component of credit risk and financial institutions should seek to diversify their lending to prevent the credit problems of any one industry, group or person from potentially impairing the capital position of the bank.

We are directing our examination and supervision staff to analyze such business structures carefully. If such related corporations or LLCs appear to be corporate shells with the above characteristics, the debt of such entities may be combined for legal lending limitation purposes. This could result in violations of 7-1-285 being cited in examination reports. Such extensions of credit will also be commented upon as Concentrations within the report of examination.

In determining whether credits are being made to related interests, examiners will consider the management structure, ownership and functional interrelationships of entities in making such a determination. It should be noted that the practice of having common individuals guarantee obligations of corporate or LLC entities as a matter of banking prudence or abundance of caution will not result in debts being combined for lending limit purposes, unless one or more of these other factors mentioned above are clearly in evidence. The Department supports the appropriate use of guarantors on such obligations, taken as a matter of banking prudence or an abundance of caution, to safeguard the interests of the bank.

We do intend to provide examiners with sufficient latitude to not combine debt when related interests have clearly separate and distinct sources of repayment, have a clear financial history with evidence of the financial capacity to service the debt, adequate net worth to protect the bank and some valid indication of secondary sources of repayment.

We understand that some bankers may have established some concentrations of credit utilizing such structures, and the Department will provide banks with some flexibility and time to work these situations out and bring them into compliance with these statutory and regulatory requirements. We cannot, however, be flexible about additional advances of credit that occur after the date of receipt of this Memorandum, which do not comply with these statutory and regulatory requirements. We expect institutions with such credit structures to bring any subsequent extensions of credit into compliance with these statutory and regulatory provisions.